



APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation (other than a personal holding company as defined in section 351) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting gains and profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

(1) 25 per centum of the amount of the adjusted net income not in excess of \$100,000, plus

(2) 35 per centum of the amount of the adjusted net income in excess of \$100,000.

(b) *Prima Facie Evidence.*—The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to avoid surtax.

(c) *Definition of "Adjusted Net Income."*—As used in this section, the term "adjusted net income" means the net income computed without the allowance of the dividend deduction otherwise allowable, but diminished by the amount of dividends paid during the taxable year.

(d) *Payment of Surtax on Pro Rata Shares.*—The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing

their returns) in their gross income their entire pro rata shares, whether distributed or not, of the "adjusted net income" of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

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Treasury Regulations 86, explaining the Revenue Act of 1934:

ART. 102-1. Taxation of corporation formed or utilized for avoidance of surtax.—Section 102 imposes a graduated income tax or surtax upon any domestic or foreign organization formed or availed of to avoid the imposition of the individual surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting gains and profits to accumulate instead of dividing or distributing them. * * * The surtax imposed by section 102 applies whether the avoidance was accomplished through the formation or use of only one corporation or a chain of corporations. For example, if the capital stock of the M Corporation is held by the N Corporation so that the dividend distributions of the M Corporation would not be returned as income subject to the individual surtax until distributed in turn by the N Corporation to its individual shareholders, nevertheless the surtax imposed by section 102 applies to the M Corporation, if that corporation is formed

or availed of for the purpose of preventing the imposition of the individual surtax upon the individual shareholders of the N Corporation. The surtax is in addition to the taxes levied upon corporations generally by Title I. For the computation of the surtax see article 102-4.

Art. 102-2. Purpose to avoid surtax.—The Act provides two *prima facie* presumptions of the existence of a purpose to avoid surtax. The fact (1) that any corporation is a mere holding or investment company, or (2) that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, constitutes *prima facie* evidence of a purpose to avoid the individual surtax. * * *

The assumed purpose to avoid the individual surtax is subject to disproof by competent evidence like any other question. Proof of the purpose, therefore, depends upon the particular circumstances of each case. In other words, the purpose may be evidenced by circumstances other than the presumptions specified in the Act. A corporation is subject to taxation under section 102 when it is formed or availed of for the purpose of preventing the imposition of the individual surtax regardless of whether it is a mere holding or investment company, or whether the accumulations, if any, are in excess of the business needs. On the other hand, the statutory presumptions will be overcome if the corporation can show, by a disclosure of all the facts, that it was neither formed nor availed of for the purpose of avoiding the individual surtax, but the mere fact that it distributed a large portion of its earnings for the year in question is not sufficient to overcome the presumption. All the circum-

stances which might be construed as evidence of the purpose can not be outlined. Among other things the following will be taken into consideration in determining the existence of such purpose: (1) Dealings between the corporation and its shareholders such as withdrawals by the shareholders as personal loans or the expenditure of funds by the corporation for the personal benefit of the shareholders and (2) the investment by the corporation of undistributed earnings in assets having no reasonable connection with the business.

ART. 102-3. *Unreasonable accumulation of profits.*—An accumulation of gains and profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent reasonable accumulations of surplus for the needs of the business if the purpose is not to prevent the imposition of the surtax. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to plant reasonable required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business. Among other things, the nature of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistrib-

uted earnings or profits will be considered in determining the reasonableness of the accumulations.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line of business which it may legitimately undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax. If one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance the business of the first corporation. Gains and profits of the first corporation put into the second through the purchase of stock or otherwise may, therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not of itself to be regarded as employment of the income in its business.

The Commissioner, or any collector upon direction from the Commissioner, may require any corporation to furnish a statement of its accumulated gains and profits, the name and address of, and number of shares held by each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 148 (c).)